**CHASE**

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Expectations the Key to Success of New U.S. Policies

The Reagan administration's estimates for the U.S. budget deficit in fiscal years 1981 and 1982 may well prove optimistic. Although the government's forecast of a \$54.5-billion shortfall this year is likely to be exceeded only slightly, the actual gap in fiscal 1982 could be dramatically wider than the \$45 billion currently projected by the new administration.

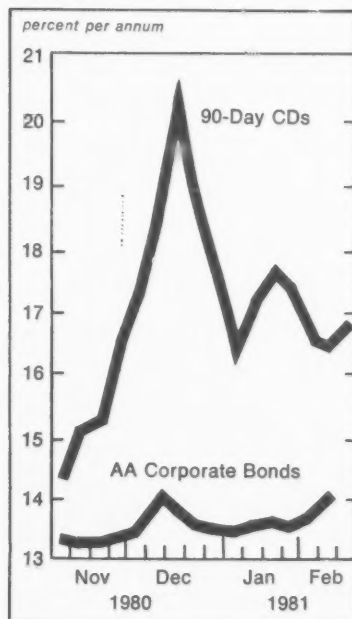
The basic premise behind the government's conservative deficit estimate for fiscal 1982 is its assumption that forceful action will dampen inflation expectations quickly. It is believed that this would then reduce interest rates and permit faster economic growth later this year, with even more rapid gains in 1982. The administration projects real GNP growth of 4.2% next year, with consumer prices rising 8.3%—a rather strong improvement over real economic growth of 1.1% and an inflation rate of 11.1% expected for 1981.

The sharp improvement seen for 1982 hinges on positive returns to the Reagan formula of comprehensive budget cuts, reduced government regulation, and restrictive monetary policy, which are aimed at dampening inflation expectations, accompanied by tax cuts to stimulate real economic growth. But there are several problems with this formulation.

First, there is concern that the tax cuts will be implemented before all the spending cuts are passed, as evidenced by bond market participants pushing AA utility bond rates up 75 basis points since the inauguration, despite a 250-basis-point drop in short-term rates. The recent weak growth in the narrow money supply that has allowed short-term rates to fall may augur a renewed economic downturn in the coming months, which could spur hasty passage of the tax cuts, confirming the bond market's fears. If the Federal Reserve accommodates the fiscal stimulus with rapid monetary expansion, adverse expectations could be fueled further, boosting inflation and dampening real growth this year and next.

But even if all the spending-cut and tax-cut proposals are passed, the surge in growth and lower inflation envisaged by the government are still unlikely to be realized quickly, largely because of the stubbornness of expectations. Past experience suggests that at least several months of sustained easing in actual inflation will be needed to lower inflation expectations. Sustained declines in inflation will not be accomplished easily, however, because of the long build-up of inflationary momentum as well as doubts about Congressional willingness to reverse the long-term trend toward larger government.

Short- and long-term interest rates



Weak mark takes precedence over recession in recent German credit tightening.

Austrian monetary policy unlikely to loosen, despite recession.

Norwegian export competitiveness and inflation under strain.

Iraqi economy running smoothly and cushioned by plentiful reserves.

The persistent weakness of the German mark has forced the Bundesbank to tighten credit, despite the domestic recession. The central bank's traditional Lombard facility—under which banks borrow funds from the Bundesbank using securities as collateral—has been temporarily withdrawn, and banks have had to repay outstanding borrowings estimated at 6.5 billion DM. Replacing the former facility is a special Lombard facility whose interest rate will be set daily by the Bundesbank. The new policy gives the monetary authorities much more flexibility in influencing the level of short-term rates, which are not only likely to rise in the near term, but also to show greater daily volatility. If exchange market speculators do not expect the German mark to be devalued against its European Monetary System partners, the recent tightening sets a floor to the DM exchange rate on forward markets. Heightened German interest-rate volatility would then be reflected in greater fluctuations in the spot DM/EMS exchange rates, or, less likely, in greater volatility in the interest rates of EMS partners.

The Austrian economy has not escaped the European recession unscathed. Real GDP is now expected to decline slightly after its estimated 3.5% growth last year. And the domestic slowdown is likely to boost the 1981 net budget deficit to 29 billion schillings from the planned level of 25 billion (although this is still below the estimated shortfall for 1980). Despite the sluggish growth of domestic demand, however, the country's current-account deficit is expected to narrow only slightly from 1980's 47 billion schillings as Austria's export markets, especially Germany, continue to weaken. Thus, the recent credit tightening in Germany would seem to preclude any early relaxation of Austrian monetary policy, which, given Austria's hard-schilling policy, is largely determined by the foreign-exchange market.

Norway is faced with a number of short-term economic problems, although its huge oil reserves make its long-term prospects uniquely bright. Some of its current problems are the product of recession among its trading partners, which is dampening exports, and others follow from the economic strains of oil development. One such strain is the rapid increase in wages enjoyed by North Sea oil workers, whose skills are in short supply and whose pay rises have tended to spread to other sectors of the labor market. As a result, the improvement in relative costs that was seen in 1978-79 has now reversed itself, a further depressing force on exports. Wage increases have also contributed to accelerating inflation. The rate of inflation reached a year-over-year rate of 13.7% at the end of 1980, and it is expected to average 13% this year. Further straining Norwegian exports is the kroner exchange rate. The kroner has begun to show signs of petrocurrency status, rising from 2.87 per deutschemark at the start of 1980 to 2.47 per DM in mid-February. All in all, however, the economy is in sound shape. The country is still running a trade surplus—1.38 billion kroner in January after a kr. 5.2-billion surplus for all of 1980. And despite the slackening of economic activity, unemployment is still less than 1.5%.

With the exception of oil exports, the Iraqi economy is reportedly functioning remarkably well, despite the war with Iran. Reports from Baghdad indicate that construction work, in particular, has continued uninterrupted. Oil exports, however, have dropped back from their peak in early December when exports through the two Mediterranean pipelines exceeded one million barrels per day. Since then, the Syrian pipeline has been closed, and exports through Turkey have only averaged some 400,000 barrels daily. Iraq, however, does not face the prospect of a foreign-exchange shortage even if exports halt completely, as conservative estimates place total foreign-exchange reserves in excess of \$20 billion. In the interim, Iraq is reported to be discussing contracts with the Japanese for shipment of 200,000-300,000 barrels per day at \$37.20 per barrel—which

could mean a renewed upturn in exports. For the longer term, the Iraqis are finalizing the details of a 1981-85 plan. Total plan expenditures of more than \$75 billion are anticipated, which will keep Iraq the second biggest Middle East market for Western companies.

Venezuela posted negative growth in 1980, but doubled its trade surplus.

Real GDP in Venezuela declined by about 1.6% in 1980, following an expansion of less than 1% in 1979. The contraction last year was primarily the result of an 8% drop in petroleum output, with production returning to a more normal level of 2.17 million barrels per day from the high of 2.36 million bpd averaged in 1979 in the wake of the Iranian shortfall. The country's non-petroleum sectors stagnated or experienced modest declines. And the rate of inflation continued at its previous year's level, averaging about 22% in the fourth quarter of 1980, on a fourth-quarter-over-fourth-quarter basis. The bright spot was the external sector. The 64% jump in average petroleum export prices pushed total export earnings to \$20 billion last year from \$14.2 billion in 1979. With imports estimated to have risen slightly to \$12.5 billion, the trade surplus more than doubled to \$7.5 billion.

Australian economic showing threatened by tight money policy at home and abroad.

The restrictive monetary policy pursued by Australian authorities in fiscal 1980/81 (ending March 31) appears to be bearing fruit. Consumer price inflation is currently running at a 9.2% annual rate, compared with 10.8% last year. And it seems that the government will meet its money growth target of 11%. Some serious risks remain, however, and the coming months are particularly important. Short-term interest rates are expected to rise to about 17%, which could undermine the recent bond market revival. Furthermore, the path of U.S. interest rates in the next few months will prove critical to the Australian economy by altering the volume of capital inflows into the country. If the interest-rate differential increasingly favors the United States, it can cause a severe credit squeeze in Australia (by aggravating a period of traditionally tight money conditions) and brake the slowly rising real annual GDP growth rate of 3.5%. Or it can accommodate credit demands, with only minor tightness at the margin.

Indonesian economy booming, paced by oil and gas.

Indonesia's is a boom economy. Real GDP growth was an estimated 9% in 1980, a record. And the momentum is continuing, with oil and gas setting the pace. Aggressive exploration activity in the last few years has lifted the rate of oil output, and rapidly expanding gas production has brought in new foreign exchange and spawned downstream chemical industries. Agriculture and commodities-based manufacturing are also doing well, and the timber processing industry is currently buoyed by a region-wide construction boom. The financial and property sectors are seeing increased business volume and profitability, owing to the strong export earnings and the government's policy of liberal spending on development. All of this activity, however, has fueled inflation. Consumer prices have been rising at a 20% rate and show no sign of moderating this year. But this is viewed as a small price to pay for the welcome prosperity.

Silver price weakness expected to continue.

Market forces are expected to keep silver prices in the \$12-\$15 range this year. Non-Socialist world demand for refined silver is projected to decline by 2% in 1981, owing to the worldwide recession, particularly in Japan, while production is forecast to increase by about 4%. And speculative demand is unlikely to be an important factor this year because of the high level of interest rates in the United States and abroad. The surplus will lead to a build-up in silver inventories; these are expected to grow some 26%, from 190 million troy ounces at the end of 1980 to about 240 million troy ounces at the end of this year. The quantity supplied is also likely to exceed the amount demanded in 1982, with a further 25% inventory accumulation estimated.

Money Targets Suggest Tightness in 1981

In testimony before Congress last week, Federal Reserve Chairman Volcker announced that the Federal Reserve's 1981 target growth ranges for the narrow money supply measures have been reduced by one-half percentage point from those of 1980. He also stated that the 1981 target growth ranges for the broader money supply measures and for bank credit would not be changed. These announcements were in line with the markets' expectations. And the new targets confirm that recent money growth has been well below target, and that the Federal Reserve plans to maintain a tight monetary stance for 1981 as a whole.

The one-half percentage point reduction in the target growth ranges for the narrow money measures—to 3½-5½% for M1-A (currency plus demand deposits) and to 3¼-6% for M1-B (M1-A plus other checkable deposits)—does not apply to the "raw" money data released by the Fed. Rather, it applies to M1-A and M1-B adjusted for the effect the nationwide introduction of NOW accounts has had and will continue to have on these money measures. NOW accounts are included in M1-B but not in M1-A, and the Fed estimates that so far about 80% of the increase in NOW accounts since the end of 1980 is related to shifts from demand deposits to NOW accounts. (The Fed is assuming that for the remainder of the year, 67% of the increase in NOWs will result from such shifts.) Thus, the actual target growth ranges are lower for M1-A (minus 4½

to minus 2%) and higher for M1-B (6½-8½%). This suggests that both measures are currently well below the lower bounds of their target ranges. And this probably explains the recent decline in the federal funds rate.

Chairman Volcker noted, however, that these adjustments in the monetary growth target ranges were tentative. Recognizing this, many financial market participants have posited that the Fed may place greater weight on the behavior of one of the broader money measures in formulating policy. Unfortunately, Chairman Volcker did not reveal the relative weights the Fed plans to attach to each of the different growth targets for the various monetary measures. Thus, if the growth rates of the various money measures begin to diverge by more than is suggested by their target ranges, it may be difficult to predict the likely monetary policy response.

It does appear, however, that the Federal Reserve's money growth targets would, if attained, constitute a tight monetary policy. The historical behavior of velocity—the ratio of current-dollar GNP to the money supply—suggests that it would take an abnormally large jump in velocity growth for current-dollar GNP to exceed 9½-10%, even if money growth were at the upper end of its target range. Thus, as Chairman Volcker noted, unless inflation abates significantly, the Fed's money growth targets would be consistent with only minimal real growth.

Reagan Grapples With Competing Doctrines

The Reagan administration's proposals to spur economic recovery while dampening inflation draw on several theoretical constructs: supply-side economics, rational expectations, and orthodox conservatism. So far, none of these economic theories has dominated the administration's policy formulation. But as the fight in Congress over the proposals intensifies, the new administration's priorities will ultimately crystallize. And this clarification will determine which items on the agenda will be subject to compromise in the legislative arena.

The *supply-side* camp has succeeded in sustaining President Reagan's commitment to the three-year, 30% Kemp-Roth tax cut for individuals and faster depreciation for businesses. The rationale is that such cuts will encourage more Americans to work harder and save more, while spurring businesses to invest more. The net result would be increased capital formation and large increases in economic output. But there is doubt among many economists that the magnitude of response to the tax cuts would be as large as supply siders claim.

Arguments by *orthodox conservatives* are guided by their concern about the size of the budget deficit. Their fears that large tax cuts—without offsetting budget cuts—would widen the deficit led to significantly smaller proposed increases in nondefense spending. Conservatives view deficits as inflationary because of

the government's temptation to lean on the Federal Reserve to allow an accommodating increase in the money supply. But the budget is not projected to be in balance until fiscal year 1984, and even then only by a slim \$500 million.

The *monetarists* contend that there is no direct connection between inflation and the size of the budget deficit. Their emphasis is that steadfast pursuit by the Federal Reserve of sufficiently low monetary growth can limit, if not eliminate, inflation. But if the Federal Reserve sticks to a highly restrictive course, realization of the rapid economic growth that the Reagan team projects would be unlikely.

Adherents to the *rational expectations* approach hold that what is most important is that the mix of policies be viewed as credible and stable—and able to achieve their desired goals. Believers in this theory maintain that the Reagan package would lower inflation expectations quickly and allow the forecast economic growth. But the speed with which this could be attained is debatable (see article on page one).

If in the coming months the financial markets judge the Reagan policies (as amended by Congress) harshly, or if the economy fails to perform as expected, a new policy mix is likely to be sought. A revised formula would most probably include new initiatives for further budget cuts and/or efforts to scale back or delay tax cuts.

Latin America Bimonthly Survey of Business and Finance

COUNTRIES	CURRENT BUSINESS CONDITIONS	EXPORTS		GNP IN 1979		BALANCE OF PAYMENTS						MONEY AND BANKING						COUNTRIES	
		6 months ending	change from year earlier	in billions of dollars	per capita	latest data	reserves (less gold) in million \$	12-month change	months of imports covered	use of IMF credit, millions of dollars	current influences on payments	12-month changes		exchange rate in U.S. dollars February 25, 1981	change from year earlier	current monetary conditions			
												latest data	consumer prices				latest data		money supply (M1)
Argentina	Exports and agriculture to benefit from faster exchange devaluation; large grain harvest expected.	June	- 16%	102.1	\$3,825	Oct.	7,804	- 15%	10.4	0	Peso devalued 10% last month.	Jan.	+ 84%	Oct.	+ 105%	.000525	- 11%	Domestic interest rates rising.	Argentina
Bahamas	Proposals to control foreign investment in real estate under study.	June	+ 15%	1.1	4,590	Dec.	92	+ 19%	0.1	0	Tourist visits down slightly.	Nov.	+ 13%	Sept.	- 1%	1.0100	+ 10%	International reserves in decline since mid-1980.	Bahamas
Bolivia	Subsidies for many goods abolished or reduced; gas and food prices raised substantially.	Sept.	+ 21%	4.8	889	Dec.	106	- 41%	1.5	80	Commitment to austerity should improve external-payments position.	Nov.	+ 51%	Oct.	+ 44%	.0425	+ 4%	Credit is restrictive.	Bolivia
Brazil	Rise of public-service charges and price decontrol may boost inflation rate temporarily.	Dec.	+ 32%	204.7	1,725	Sept.	5,308	- 43%	2.5	0	Oil import volume reduced.	Jan.	+ 111%	Dec.	+ 71%	.0150	- 33%	Local interest rates freed.	Brazil
Chile	Preliminary data show 6.5% real GDP growth last year; construction led with 17% gain.	Nov.	+ 9%	20.6	1,860	Dec.	3,123	+ 61%	6.1	123	Current-account gap widened to \$1.6 bn. in 1980 from \$890 mn. in 1979.	Dec.	+ 31%	June	+ 65%	.0270	+ 5%	Net foreign assets rising.	Chile
Colombia	Foreign direct investment rose more than \$1 billion last year, led by coal mining projects.	Oct.	+ 16%	28.2	1,070	Dec.	4,831	+ 26%	12.3	0	Current-account surplus reduced because of lower coffee prices.	Nov.	+ 26%	July	+ 19%	.0225	0	Domestic bank credit increases sharply.	Colombia
Costa Rica	Fiscal and balance-of-payments positions deteriorating.	Nov.	+ 12%	3.9	1,760	Nov.	108	+ 14%	0.9	57	Exchange rate unified; local dollar futures market launched.	Oct.	+ 18%	Oct.	+ 8%	n.a.	-	Liquidity is tight.	Costa Rica
Ecuador	Emergency economic program boosts domestic oil-product prices by 200%-300%.	May	+ 47%	8.6	1,064	Dec.	1,066	+ 48%	5.6	0	Higher prices boost oil export earnings.	Nov.	+ 15%	Sept.	+ 29%	.0365	- 9%	New limits placed on credit expansion.	Ecuador
El Salvador	Wage and price controls imposed to reduced 125% inflation rate.	Sept.	+ 3%	3.5	750	Dec.	78	- 45%	1.0	-	Import restrictions imposed and foreign-exchange restrictions tightened.	Oct.	+ 17%	Oct.	+ 12%	n.a.	-	Net foreign assets declining.	El Salvador
Honduras	Real economic growth slowed to about 2% in 1980 from 7% in 1979.	Aug.	+ 4%	2.1	579	Oct.	152	- 5%	1.7	15	Coffee output drop of 15% hurt export growth last year.	July	+ 21%	Sept.	+ 8%	.5010	0	Some capital flight apparent.	Honduras
Mexico	Economic activity brisk, but industrial output rate declining because of capacity constraints.	Oct.	+ 73%	121.3	1,749	July	2,466	+ 26%	1.4	0	Non-oil exports growing slowly.	Nov.	+ 29%	Mar.	+ 48%	.0435	- 1%	External public debt reached \$34 billion in 1980.	Mexico
Nicaragua	Real GDP advanced 14% last year, substantially less than hoped for by authorities.	Dec. '79	- 5%	1.7	660	Nov.	85	+ 42%	4.5	49	Agriculture and exports hurt by expropriation fears, labor and credit shortage.	Dec. '79	+ 68%	Aug. '79	+ 55%	.1015	+ 2%	Credit is scarce.	Nicaragua
Panama	Buoyant investment spending contributed to 5% real GDP growth in 1980.	Sept.	+ 21%	2.8	1,469	Nov.	80	- 28%	1.0	23	Current-account gap widening, owing to trade deficit.	Oct.	+ 14%	Sept.	+ 26%	Par	-	Credit growth is steady.	Panama
Paraguay	Economic activity steps up sharply, paced by large hydroelectric projects.	Oct.	- 6%	3.4	1,144	Dec.	762	+ 25%	14.7	0	Timber exports increase significantly.	Oct.	+ 17%	Oct.	+ 20%	.0080	0	International reserves rise strongly.	Paraguay
Peru	Real economic growth estimated at 3% in 1980, well below government target of 5%.	Sept.	0	13.0	752	Nov.	1,922	+ 63%	8.2	474	Trade surplus totaled \$1 billion last year, down from \$1.4 billion in 1979.	June	+ 54%	May	+ 88%	.0029	- 25%	Interest rates increased.	Peru
Trinidad & Tobago	New discoveries of natural gas supplement the country's petroleum resource potential.	Sept.	+ 56%	4.5	3,945	Dec.	2,780	+ 30%	11.2	0	Current-account surplus enlarged by oil sales.	Oct.	+ 17%	Sept.	+ 23%	.4200	0	Credit demand is strong.	Trinidad & Tobago
Uruguay	Inflation cut to 43% in 1980, largely the result of slowdown in devaluation pace.	June	+ 16%	6.9	2,372	Oct.	416	+ 30%	3.2	0	Exchange-rate policy calls for 6% devaluation of peso by May.	Oct.	+ 58%	Sept.	+ 32%	.1005	- 14%	Net foreign assets rising.	Uruguay
Venezuela	State holding company publicizes its decision to sell some 40 companies to private sector.	Aug.	+ 44%	48.9	3,619	Dec.	6,581	- 10%	7.3	0	Official authorizations of foreign investment doubled to \$420 million in 1980.	Oct.	+ 23%	Sept.	+ 14%	.2335	0	International reserves declining.	Venezuela

World Interest Rates

market rates of Feb. 25, 1981; bond yields as of Feb. 20, 1981

in percent per annum	U.S.	Canada	Britain	Belgium	France	Germany	Italy	Netherlands	Switzerland	Japan
Central Bank Discount Rate	13.00 penalty-large banks 16.00	17.14	14.00	12.00	9.50	7.50	16.50 penalty rate 19.50	8.00	3.50	7.25
Day-to-Day Money	14.875 Feb. 26	18.00	14.50	8.55	11.25	17.00	17.50	9.00	3.25	8.5625†
Treasury Bills 91-day, Middle Rates	14.16	16.80	12.00	12.75	n. a.	n. a.	15.30 64-day	no dealing	no market	5.875† 2-month
Commercial Paper prime, 3-month, asked	14.00 finance paper	17.00 finance paper 15% tax w/h	12.184*	11.50 Certified	12.875 Interbank	no market	no market	no market	no market	not traded
Bankers' Acceptances 3-month, asked	14.65	16.90 15% tax w/h	12.625*	11.80 Certified	not traded	9.90	19.65	no market	4.50	no market
Government Bonds Long-term, new and old issues, average yield	12.56	13.95	13.67	11.46 20% tax w/h	14.20	9.97	16.55	11.03	4.99	8.33
Industrial Bonds prime, long-term, new and old issues, average yield	13.55 Aa Industrials	14.25	14.15	15.49	15.19	10.06	17.02	11.69	6.10	7.01
Bank Short-Term Rate to Best Borrowers (prime rate)	19.00	18.25	15.00	15.50	13.85	12.25	21.00 1/4 quar'tly fee on outstg.	11.00	6.00	7.50†
Bank Time Deposits 3-month	14.875 Cert. of Dep.	16.25	12.50	13.00	13.00	12.75	10.75	10.375 large deposits	7.50 residents only	5.00† 20% tax w/h
Eurocurrencies 3-month, asked	16.875	no market	12.50	no market	13.25	14.75	no market	10.50	8.50	no market
Exchange Rates—in U.S.\$ rates floating against the \$	—	.8333	2.2300	.028935	.2020	.4732	.00098	.4278	.5201	.004817
Forward Exchange Cover 3-month, in percent p.a. D = discount, P = premium	—	.50 D	4.00 P	3.00 P	3.00 P	2.50 P	2.25 D	6.25 P	7.00 P	7.375 P
Eurodollar Deposits (London, interbank, bid) Feb. 26	International Arbitrage (3-month, hedged) + in favor of U.S. dollars				Eurobonds (average yield on recent straight debt issues)			Gold Price		
7-day 15.125	U.S.-U.K. Treasury Bills n.a.				U.S. Dollar Bonds			London		
1-month 16.00	U.S.-Canada Treasury Bills -1.15				7 yrs. and under 14.25			afternoon fixing		
3-month 16.5625	U.S.-Canada Finance Co. Paper -2.27				Over 7 yrs. 14.50					
6-month 16.5625	Eurodollars-U.K. Local Auth. Deposits n.a.				DM Bonds			500.50		
					7 yrs. and under 10.50			(per fine ounce)		
					Over 7 yrs. 10.25					

The above interest rate quotations refer to the past week and may not be construed as offers by The Chase Manhattan Bank. The quotations for Bank Short-Term Rate to Best Customers, while including customary commissions, reflect neither possible other fees nor varying compensating balance requirements.
* Market rates as of Feb. 10. † Market rates as of Feb. 18.

Current economic indicators of major industrial countries

	U.S.	Canada	Britain	France	Germany	Italy	Switzerland	Japan
Consumer prices*	11.7 (Jan.)	12.0 (Jan.)	13.0 (Jan.)	12.8 (Jan.)	5.8 (Jan.)	21.1 (Dec.)	5.1 (Jan.)	7.3 (Jan.)
Industrial production*	-0.6 (Jan.)	-1.7 (Nov.)	-10.9 (Dec.)	-2.2 (Dec.)	-5.6 (Dec.)	-3.8 (Dec.)	4.0 (Sept.)	3.9 (Dec.)
Trade balance† (billions of local currency units)	-\$2.98 (Dec.)	C\$0.50 (Dec.)	£0.76 (Jan.)	-FF8.40 (Jan.)	DM1.01 (Dec.)	-Lit.1,300 (Dec.)	-SF0.39 (Jan.)	-¥292 (Jan.)
Money supply (M₁)*	4.1 (Dec.)	8.5 (Dec.)	1.6 (Oct.)	8.3 (Oct.)	6.0 (Nov.)	15.9 (Sept.)	-7.4 (Oct.)	-1.6 (Nov.)
Velocity of money (M₁)*	4.6 (Dec.)	10.7 (June)	8.7 (June)	n. a.	3.0 (Sept.)	6.6 (Sept.)	n. a.	12.6 (Sept.)
Reserves minus gold (\$ million, change from previous month)	1,090 (Dec.)	565 (Dec.)	-813 (Dec.)	-1,240 (Dec.)	-240 (Dec.)	131 (Dec.)	2,921 (Dec.)	328 (Dec.)

* Percent change from 12 months earlier.

† Figures are only for the month indicated.

Oil Windfall Boosts Algerian Economy

Algeria's economic planners have been given new breathing room in the form of the recent surge in oil and gas prices. Average prices for Algerian hydrocarbon exports last year, which account for 98% of export earnings, were up 77% over 1979. The windfall bolstered Algeria's weakened financial position and gave its authorities the flexibility to cut oil output and boost imports, yet still erase a current-account deficit and ease the country's high debt service burden.

The increased oil earnings have led the government to push new oil and gas projects into the future to preserve resources, and focus greater attention on agriculture. Higher agricultural productivity is seen as vital for a sector that employs nearly half the population and in the face of a soaring food import bill. Nonetheless, the hydrocarbon sector will continue to dominate Algeria's economy—although it generates only about 1% of total employment. The rapid growth in export earnings projected through the early part of the next decade will provide the financial resources for both industrial and agricultural investment. The acid test, however, will be Algeria's ability to develop a strong non-hydrocarbon productive base to drive economic growth when its hydrocarbon earnings begin declining.

Characteristics of the economy

Algeria is generally regarded as a high-absorbing member of the Organization of Petroleum Exporting Countries, owing to its large population (19 million) and its ambitious development goals. The economy has been characterized by high levels of investment (50% of GDP in 1979) and heavy demand for imports, mainly capital goods and raw materials. The country's balance of payments has accordingly been weaker than the lower-population members of OPEC, and it has borrowed heavily in world financial markets. Its development strategy has consisted of austerity in consumption to permit rapid exploitation of hydrocarbon resources and heavy investment in manufacturing, transportation, and communications.

The hydrocarbon sector is clearly the star of Algeria's \$25-billion economy; the sharp oil price gains of 1979 boosted the contribution of oil and gas to GDP to an estimated 40% from 28% as recently as 1978. Yet by OPEC standards, Algeria is far from being a major producer. Crude oil output has been relatively stable at 1.0-1.2 million barrels per day, and is currently running 900,000 bpd with exports of some 790,000 barrels. Moreover, petroleum resources are limited. Proven reserves are put at 8.4 billion barrels, sufficient to last 25 years at present output levels.

The country's greater wealth lies in its substantial reserves of natural gas. Proven reserves are 132 trillion

cubic feet—the fourth largest in the world. Exploitation to date has been relatively minor, but development plans envisage heavy investment in LNG facilities and, more recently, in more cost-efficient pipelines to Europe—despite the recent cutback in investment plans and reduced export targets. The Algerians are pushing hard for price equivalence between their petroleum and natural gas exports. In fact, exports of LNG to France and the United States were interrupted for several months last year and still have not resumed to the United States. (Algeria initially sought \$6.11 per million BTUs f.o.b., but the negotiating range is currently \$4.00-\$4.50.)

Apart from oil and gas, Algeria has managed to establish an adequate domestic manufacturing base. The manufacturing sector contributed 13% to GDP and provided 16% of employment in 1979. And it is well diversified among food products, heavy industry, textiles, chemicals, and construction. Heavy industry received strong emphasis in the 1970s, and industrial output rose 13.6%, on an annual average basis, between 1974 and 1977.

Despite real gains in output, the agricultural sector lost ground in the 1970s. The decade witnessed an agrarian revolution in which property was distributed to landless peasants and organized into production cooperatives. But until only recently, agriculture received diminishing attention from the government. It currently contributes only about 7% to GDP, while employing 43% of the population. Although food production did exceed population growth in the 1970s—owing to the government's emphasis on import substitution—rapidly rising incomes and a national birth rate of over 3% stimulated demand even more, causing food imports (mainly of wheat) to grow strongly. The 1979 food import bill was \$2 billion, equal to more than 20% of total export revenues.

Despite Algeria's political leanings toward the Third World and Eastern Bloc, its economy is tied to the West. In 1979, the European Economic Community countries purchased 37% of Algerian exports and the United States, 53%. And import data show that France, Germany, Italy, and the United States satisfy nearly 60% of Algeria's total import needs.

Algeria's average annual economic growth was 6%-7%, adjusted for inflation, for most of the 1970s, with nominal GDP soaring more than 50% in 1974 when oil prices quadrupled. The fast growth was fueled by rapidly rising oil revenues and returns from high levels of productive investment in manufacturing, construction, and agriculture.

But the gains were not achieved without a build-up

Oil Windfall Boosts Algerian Economy *(continued from page 7)*

of inflationary pressure. Official consumer price data point to an annual average inflation rate of 10.4% between 1973 and 1979, with the rate peaking at over 17% in 1978. And these figures understate underlying inflationary pressure because of the prevalence of controlled prices—especially for food.

Despite the size and growth of hydrocarbon earnings, Algeria's balance of payments has been consistently weak. High export revenues have been more than offset by high imports associated with growing investment spending and food imports. A current-account surplus was achieved in 1974 following the oil price explosion, but spending rose steadily, and by 1978 the current-account balance was in deficit by \$3.5 billion. The deficit narrowed slightly to \$1.7 billion in 1979, owing to soaring oil and LNG export earnings and to reduced import growth stemming from reduced investment and import restrictions.

Algeria has financed its external-account deficits with substantial long-term borrowings by the public sector, supplemented by long-term project-specific export credits. The Euromarket has been the major source of the financings. The heavy Euromarket borrowings, which eased only as recently as 1979, permitted a steady growth in official reserves. By the end of 1979, foreign-exchange reserves reached \$700 million, with official reserves at \$5.4 billion, enough to finance over eight months of imports. But the sustained large borrowings also raised total disbursed external debt to \$15.5 billion at the end of 1979. Debt service requirements rose to \$2.6 billion in 1979, versus \$1.5 billion in 1978, pushing the debt service ratio up to 26% from 22% in 1978.

The economy in 1980

Economic developments in Algeria last year were dominated by the impact of the sharp rise in oil prices. The average contract price for a barrel of Algerian Saharan 44° was \$37.40, compared with \$21.10 in 1979. This dramatic increase allowed the authorities to cut oil output to 1.0 million barrels per day last year from 1.14 million bpd in 1979 and reduce LNG exports, yet still realize an estimated \$14 billion in hydrocarbon export revenues (versus \$9.3 billion in 1979). The large revenues permitted a slight relaxation of import controls to alleviate the chronic shortage of consumer goods. This spurred a 28% jump in imports, which totaled an estimated \$10 billion. But despite the import jump and a rise in interest payments on foreign debt—to about \$3.3 billion—a balanced current account appears to have been attained after five years of deficits. And the strong export earnings reduced the country's debt service ratio from 26% to a more manageable 22%. Overall, real economic growth is esti-

mated at a low 3% in 1980, owing to the impact of the cut in hydrocarbon output.

The near-term outlook

The 1980-84 development plan provides some indication of the authorities' change in the emphasis of development policy. The plan projects expenditures of about \$15 billion a year (in 1979 prices), equivalent to 45% of annual GDP. It is still heavily biased toward industry (39%), although hydrocarbon expenditures will decline by the end of the period as major projects are completed. Agriculture is targeted for 12% of total plan investments, a share that is comparable with the previous plan, but implementation, which has been poor in the past, is expected to be rigorous this time.

The balance of payments is projected to perform favorably through 1986. The reasons include continued strong hydrocarbon prices and major output increases of LNG and LPG, in addition to new gas pipelines coming on stream. Hydrocarbon exports are forecast to grow from some \$14 billion last year to over \$44 billion in 1986. Even allowing for a major increase in imports, the current account is likely to post small annual surpluses through 1986.

Algeria is expected to return to the international capital market in 1981 and onward, largely to roll over maturing debt. And whenever feasible, it is expected to take advantage of export credits granted by foreign governments at preferential rates. Debt servicing requirements are projected to reach \$5½ billion by 1986. But the huge growth of export earnings is expected to produce a steadily declining debt service. The ratio is expected to drop from its peak of 26% in 1979 to some 12% by 1986, implying an increasing ability to raise external finance.

A strong real economic growth performance is also anticipated for the next few years—averaging more than 8% per annum. Hydrocarbon output should be bolstered by a new gas scheme coming on line, and large returns are likely from the historically high investment level, which will be sustained during the plan period.

In sum, oil profits have made Algeria's economy viable. And the financial strength of the hydrocarbon sector will more than compensate for structural weakness elsewhere. Beyond 1986, the growth of export revenues is projected to slow, however, as will import growth. And in the mid-1990s, hydrocarbon export revenues are expected to begin declining unless new discoveries are made. Thus, the challenge to Algerian planners is to achieve broad-based industrial, agricultural, and infrastructural development sufficient to sustain real economic growth when hydrocarbon earnings peak.

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